North Carolina
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To: Finance Officers of Counties, Municipalities, Boards of Education, Public Authorities, and Certified Public Accountants

From: T. Vance Holloman, Director
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Subject: Recently Released Governmental Accounting Standards Board (GASB) Statements

The GASB has released several statements that may impact the financial reporting requirements of local governments and public authorities for fiscal years ending in 2004, or 2005. These statements are: Statement No. 39, *Determining Whether Certain Organizations are Component Units*; Statement No. 40, *Deposit and Investment Risk Disclosures;* and Statement No. 41, *Budgetary Comparison Schedules-Perspective Differences*. These statements are reviewed in this memorandum. In addition, GASB has issued three other statements that may impact units in future years, Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries,* Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* and Statement No. 44, *Economic Condition Reporting: The Statistical Section.*

GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units an amendment of GASB Statement No. 14.* GASB Statement No. 14, *The Financial Reporting Entity*, established the criteria for determining whether a legally separate entity should be reported as a component unit. A portion of Statement No. 14 deals with circumstances under which an organization would be a component unit even though the primary government is not financially accountable. Statement No. 39 amends Statement No. 14 by establishing additional criteria for determining whether a legally separate tax-exempt organization that raises and holds resources for the direct benefit of a unit qualifies as a component unit.

In order for a legally separate organization to be reported as a component unit of a primary government (PG) or that government's component units (PGCU), all three of the following criteria must be met:

1. The economic resources received or held by the organization are entirely, or almost entirely, for the benefit of the PG, PGCU or the PG's constituents.
2. The PG or PGCU is entitled to or can access a majority of the economic resources received or held by the organization in question.
3. The economic resources received or held by an individual organization, which the PG or PGCU can access, are significant to the PG.

The first criterion requires that a single PG or PGCU get the majority of the organization's resources. If the organization in question passes its resources on to several other organizations, this criterion will probably not be met. For instance, many charter schools receive support from a nonprofit organization. If that nonprofit organization also passes its resources to other entities, it would not be a component unit of the charter school. If it did meet the first criterion, the other criteria also must be evaluated to determine if the nonprofit is a component unit of the charter school.

In determining if the second criterion is met, it is not necessary for the PG or PGCU to receive resources from the organization during the reporting period. Past receipt of a majority of the organization's resources or successful request for resources would satisfy the second criterion. Also, if the organization and the PG or PGCU are financially interrelated, the second criterion is met, regardless. "Financially interrelated" means that one organization can influence the operating and financial decisions of another and one organization has an ongoing financial interest in the other. Organizations that satisfy this requirement may already be reported as component units under Statement No. 14 because the PG is financially accountable for the organization in question.

The third requirement, that the resources be significant to the PG, is intended to eliminate from consideration small organizations such as booster clubs or PTA's. The term significant is measured against the entire PG, not individual funds or activity types. Further, the determination will be made for each individual organization, not a group of similar organizations. Professional judgment should be used in determining what is significant.

School systems receive support from booster clubs, PTA's, and other similar organizations. For any one of these to be included as a component unit of the school system, the amount contributed by a single club or PTA would have to be significant to the school system as a whole. Considering all the local, federal, and State funds received and expended by a school system, no single club or PTA would provide a significant amount of resources; subsequently, it would not be reported as a component unit. A foundation of a small public authority could potentially meet this criterion and would be reported as a component unit if the two other criteria are met.

If a tax exempt organization meets all three criteria, it would be reported as a discretely presented component unit. If an organization satisfies some but not all of these criteria, it should be evaluated as a potential component unit under the criteria of GASB Statement No. 14 if it would be misleading to exclude the organization.

Statement No. 39 will be effective for fiscal years beginning after June 15, 2003, which is the fiscal year ending June 30, 2004 for most units. We anticipate that this Statement will have limited impact in this State, except that it clarifies that most of these organizations would not be involved in the financial reporting entity because they are not significant to the primary government. The illustrative financial statements prepared by this office already include examples of the reporting of discretely presented component units. We will not be making any changes to the illustrative financial statements as a result of Statement No. 39.

GASB Statement No. 40, *Deposit and Investment Risk Disclosures an amendment of GASB Statement No. 3*. GASB Statement No. 40 resulted from the GASB's review and assessment of the adequacy and usefulness of note disclosures required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. As a result of that review and assessment, the custodial credit risk disclosure note has been modified. Note disclosures of fair value and investment activity during the year have been eliminated. Additional disclosures have been added concerning investment credit risk, concentration of credit risk, interest rate risk, interest rate sensitivity and foreign exchange exposures.

Under Statement No. 3 all deposits and investments evidenced by securities had to be classified into one of three categories based upon the level of custodial credit risk. Under GASB Statement No. 40, this requirement has been replaced with an exception based reporting approach. The custodial credit risks will only be disclosed for those deposits and investments that would have been reported in Category 3 under current Statement No. 3 reporting requirements. These deposits and investments are subject to substantial custodial credit risk as defined by Statement No. 40. The fact that an investment, such as a mutual fund, is not subject to collateralization will not be disclosed.

Category 3 deposits are those that are not covered by depository insurance, or collateral, or for which the pledged collateral is not held by the unit's agent or by a financial institution's trust department or agent in the unit's name. Category 3 investments are those that are not insured; not registered in the unit's name; and those that are held either by the counterparty, or its trust department or agent but not in the unit's name.

The focus for deposit and investment disclosures will be potential future losses. Therefore, disclosures of activities and risk during the year that differ from the year-end disclosures will not be made. However, any material violation of deposit or investment laws during the year must be disclosed as a stewardship violation. With the implementation of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, investments are usually reported at fair value in the financial statements. Therefore, a disclosure of fair value in the notes is not needed.

Four additional risk disclosures for deposits and investments have been added as a result of GASB Statement No. 40. Credit risk, the risk that an issuer or other counterparty to an investment will not fulfill their obligations, must be disclosed for investments. Credit ratings must be disclosed for all debt securities except debt securities of the United States government and those explicitly guaranteed by the U.S. government, such as GNMA securities. Most government agencies are not explicitly guaranteed and would require a credit risk disclosure. The ratings of debt securities held through external investment pools and mutual funds also should be disclosed including the North Carolina Capital Management Trust (NCCMT) Cash Portfolio which has an AAAm rating. A statement to the effect that the pool is unrated is required for the NCCMT Term Portfolio and the State Treasurer's S.T.I.F. account. Aggregate amounts may be presented by rating categories set by national ratings agencies such as Fitch, Moody's or Standard & Poor's. If the ratings of some investments are not available, this also should be disclosed.

Credit concentration risk results from not adequately diversifying investments. If a unit has 5 percent or more of its investments in securities of a single debt issuer, this must be disclosed in the notes. This determination is made based upon the issuer of the debt. Concentration risk for an investment pool or mutual fund, such as S.T.I.F., NCCMT Cash Portfolio, and the NCCMT Term Portfolio, will not be reported. Again, debt securities of the United States government, and those explicitly guaranteed by the U.S. government will not be subject to this disclosure requirement.

Interest rate risk is the risk that fair value of an investment will fluctuate because of changes in interest rates. The longer an investment is held, the greater this risk will be. This risk may be disclosed by showing the amount of investments that will mature by time segment, listing all investment maturity dates, disclosing the weighted average maturity of investments or disclosing the investment's duration. Units may also disclose what the anticipated impact of various interest rate changes would have been upon the value of its investments. The disclosures should be made in the manner most consistent with how the unit actually manages interest rate risk. Investments in external pools other than 2a7 or a 2a7-like external investment pool must be disclosed. Therefore the NCCMT Cash Portfolio as a 2a7 investment pool is exempt. The NCCMT Term Portfolio and the State Treasurer's S.T.I.F. account will require interest rate risk disclosures. U.S. Government securities will be included in this disclosure.

Investments highly sensitive to interest rate changes must be disclosed either separately or within the method chosen for interest rate risk disclosure. This means that any unique terms or conditions that potentially increase an investment's sensitivity to interest rate risk, such as coupon multipliers, benchmark indices, and embedded options, should be disclosed. These complex terms and additional requirements will not apply to most local government investments since investments of this complexity are rarely held. If the specific identification method is used for reporting interest rate risk, the statement does require that "call" provisions be disclosed. The other methods are considered to adequately disclose the effect of call provisions without a separate disclosure. Units of government in North Carolina should not have to make disclosures for foreign exchange exposures; units should not be holding any investments denominated in foreign currency.

For any risk faced by the unit, the unit's policy regarding that risk should be disclosed in the notes. Risk disclosures applicable to the unit should be presented by investment type. The focus of deposit and investment risk disclosure is typically the primary government as a whole. However, if the risk exposure is significantly higher at a lower level of reporting, that risk should be disclosed; i.e. higher levels of a particular risk for activity type (governmental or business-type), individual major funds, aggregated nonmajor funds and fiduciary funds should be disclosed.

Statement No. 40 will be effective for reporting periods beginning after June 15, 2004, which is the fiscal year ending June 30, 2005 for most units. Statement No. 40 will eventually impact the note disclosures of most units. While units are not required to implement Statement No. 40 for the 2004 fiscal year, we do encourage them to do so if possible. The illustrative financial statements for Carolina County will be updated as of June 30, 2004. Any units that elect to early implement Statement No. 40 should follow the guidance in the statement.

<u>GASB Statement No. 41, *Budgetary Comparison Schedules-Perspective Differences.*</u>
GASB Statement No. 41 addresses the presentation of budgetary comparisons when a unit of government does not adopt its budget by fund. GASB Statement No. 34 requires budgetary comparisons for the General Fund and major special revenue funds that adopt annual budgets to be in the basic financial statements or required supplementary information (RSI). In North Carolina, all units must present these budgetary comparisons in the basic financial statements. GASB Statement No. 34 does not permit the presentation of budgets for other funds in the basic financial statements or RSI. If a unit adopted a budget for an activity that is reported in several funds, uncertainty existed about how to present budgetary comparisons for these activities.

Statement No. 41 amends Statement No. 34 to require a unit whose budgetary structure is significantly different from its fund structure for financial reporting purposes to present its budget in RSI. This budgetary comparison should be based upon the structure of the legally adopted budget and should include the activities that are reported in the General Fund and major special revenue funds that adopt annual budgets. Statement No. 41 would be implemented at the same time as GASB Statement No. 34.

All local governments and school systems that adopt their budgets in accordance with G.S. Chapter 115C or 159 are required to adopt a budget for each fund. Therefore, Statement No. 41 will not apply to these units. Charter schools are not required to adopt budgets by funds, although they are encouraged to do so by this office and the Department of Public Instruction. Since all charter schools will implement GASB Statement No. 34 for the year ended June 30, 2004, Statement No. 41 also will apply for the fiscal year ended June 30, 2004. Charter schools will always present their budgetary comparison as supplemental information, since there is no statutory requirement to adopt budgets. The illustrative financial statements for Cardinal Charter School will include a budgetary comparison prepared in accordance with GASB Statement No. 41.

In addition to the new statements discussed above, GASB has issued the following statements that will be implemented in future years. These statements will be more thoroughly discussed in future memorandums.

<u>GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.*</u> Statement No. 42 requires units to report capital asset impairments in the financial statements. A capital asset will be impaired if a significant and unexpected decline in the service utility of the asset occurs. The Statement provides guidance on how to value impaired capital assets and to report losses from impairment of assets. Statement No. 42 also addresses how to report insurance recoveries.

Units are not required to write down assets or recognize losses because an asset is no longer being used at its full capacity, as long as the asset is being used for the purpose it was acquired or constructed. For example, if a major water customer was to close, the water plant of the unit would not have to be written down simply because its full capacity was not being used.

Statement No. 42 is effective for fiscal periods beginning after December 15, 2004, the fiscal year ending June 30, 2006 for most units. The illustrative financial statements will not be updated for Statement No. 42 at this time.

GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. Statement No. 43 establishes reporting requirements for other post employment benefits plans and replaces the guidance in GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. It will apply to financial statements of individual units with OPEB trust funds that are included in a unit's financial statements, as well those of stand alone plans or retirement systems. The guidance is similar to that issued for pension plans.

Statement No. 43 will be implemented in three phases, based upon the phase in which the unit was required to implement Statement No. 34. The three phases will implement Statement No. 43 between the fiscal years ending June 30, 2007 through 2009. The illustrative financial statements will not be updated for Statement No. 43 at this time.

GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section*. GASB Statement No. 44 will make the statistical sections included in the comprehensive annual financial reports (CAFR) issued by units more useful and comparable. It does not require governments to prepare a CAFR; however, it does apply to any statistical section that is presented with a government's financial statements. It will be effective for the fiscal year ending June 30, 2006. This office does not currently prepare an illustrative CAFR.

If you have any questions about this memorandum please contact Sharon Edmundson (919-807-2384 or sharon.edmundson@treasurer.state.nc.us) or Sara Shippee (919-807-2356 or sara.shippee@treasurer.state.nc.us).